Consumer Federation of America

TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE,
CONSUMER FEDERATION OF AMERICA

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

REGARDING

PROPOSALS TO REFORM THE NATIONAL FLOOD INSURANCE PROGRAM

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Mr. Chairman and members of the Committee, I appreciate the invitation to appear before you today to discuss current issues regarding the National Flood Insurance Program. I am J. Robert Hunter, Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. As Administrator, I ran the National Flood Insurance Program (NFIP) in the 1970s.

I love the National Flood Insurance Program. I poured 10 years of my life into getting it started. If it worked as Congress intended it to work, it would bless the nation by making sure new building in areas prone to flooding was wise and provide coverage to all Americans exposed to high flood hazard. The program would not allow unwise construction in the highest risk velocity (or "V") zones and would require elevations to the true 100-year flood line, at least in the other high-risk ("A") zones.

I say this as background because I must sadly raise the question of whether the flood insurance program should be ended. If the program encourages unwise construction in flood plains, it is a danger to the nation rather than a blessing. If the program lures people into flood plains, if it subsidizes construction in unsafe places, if it can't stop communities that defy the program's mitigation requirements, if it falsely assures people that they are in a low-risk area that does not need flood insurance, then it must be reformed to keep the promises of safer construction made to the taxpayers when the program was begun or it must be abolished.

I also love New Orleans, my birthplace. I have been a strong advocate for the poor. My heart is broken by the situation facing many low income residents of New Orleans. However, we cannot afford to ignore unwise construction or reconstruction in New Orleans. News reports indicate that the city may be allowing people with damage to their homes in excess of 50 percent to rebuild without elevating their homes to the 100-year level, in wholesale violation of the requirements of the NFIP.[1] It is not doing lower income residents in high-risk areas a favor to let them build the same way as before Katrina. This is just setting them up for destruction by the next flood.

FEMA must not allow sympathy for beleaguered New Orleans residents to stop it from doing what is necessary to allow the NFIP to survive. The program must be enforced if the program is to work. I support helping the residents with direct aid, if necessary, to rebuild properly or move to higher ground. But we cannot afford, as a nation, to allow rebuilding in high-risk areas without proper first-floor elevation. If Congress allows this, how could the 50 percent rule be enforced ever again? If a flood hits in Ohio, how could the 50 percent rule be enforced there, but not in New Orleans? To allow the wholesale violation of rules in New Orleans will destroy the NFIP. FEMA must suspend New Orleans from the program if it does not comply with the program's standards.

The program should also be terminated if the maps are not kept current. The antiquated maps in use right now are a disgrace. When I was Administrator of this program, we had a goal of updating the maps every three to five years. Even at that fairly frequent rate, I was considering

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[1] Jeffrey Meitrodt, "Permit appeals pay off for N.O. residents; FEMA concerned about city's leniency," *The Times-Picayune*, January 15, 2006.

adding freeboard (extra height over the 100-year level) because development drives up surface elevations. It is like sitting in a bathtub in which the water goes up as you sit down. If you put on weight, the water level goes higher. New development is like putting on weight. Lots of development drives the water level much higher.

Consider Hancock County, Mississippi. There are 76 different maps covering most of that county on FEMA's webpage. These maps, called "Hurricane Katrina Surge Inundation and Advisory Base Flood Elevation Maps," are a "smoking gun" that demonstrates how FEMA's lack of action contributed to the destruction and loss of life caused by Hurricane Katrina. They show that the antiquated 100-year flood levels are woefully out of date and extremely low.

Consider map MS-E8.[2] In this area, Katrina's surge was 23 to 24 feet above sea level. The current map required structures to be built at 14 to 19 feet above sea level at the waterfront and 11 to 13 feet elsewhere in the county, but the revised suggested elevations are 20 to 30 feet throughout the entire area. Thus a person who just prior to Katrina built to FEMA's standard, was building about 10 feet below the real 100-year risk. This was a disaster waiting to happen because of FEMA's incompetence.

Consider map MS-G8.[3] Here, a person complying with FEMA's 100-year map just before the hurricane hit would have elevated to between 9 and 11 feet above sea level. The real 100-year risk was at 18 to 27 feet. Katrina came in with elevations of 19 to 24 feet, so people were building 10 feet or more below the real risk level. On average, the V zones in the entire county were 12 feet too low when comparing current maps with the new proposals. For A zones, the average shortfall was 13 feet. These old maps are a tragedy for the nation. People all over the country are building what they think are safe homes but, to varying degrees, are not. They are in peril.

Taxpayers are subsidizing unwise construction as a result of these bad maps. Actuarial rates are predicated upon the maps and if they are too low, huge federal taxpayer subsidies of unwise construction occur. Further, large areas that appeared to be outside of the special flood hazard area should actually be in the high-hazard area. People who should have been warned that their homes were in high-risk areas were not warned and many of these, who had mortgage commitments over the past two decades or more, would have been required to purchase insurance had the maps been up to date. In Hancock County, for example, a lot more people would have had flood insurance when Katrina hit. If maps are not quickly brought up to date and kept that way, the program should be terminated.

OTHER NFIP ISSUES IN THE WAKE OF KATRINA

As I told you when I last addressed the Committee, I have several ideas for your consideration on some of the key questions that this tragic hurricane raises:

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[2] http://www.fema.gov/hazards/floods/recoverydata/maps/katrina_ms_topo-e8.pdf
http://www.fema.gov/hazards/floods/recoverydata/maps/katrina_ms-e8.pdf

[3] http://www.fema.gov/hazards/floods/recoverydata/maps/katrina_ms_topo-g8.pdf
http://www.fema.gov/hazards/floods/recoverydata/maps/katrina_ms-g8.pdf

1. Long-term Solvency

Obviously, Congress cannot decide not to pay legitimate claims to those persons holding flood insurance policies. These policies have the full faith and credit of the country behind them. But Katrina and the other storms, with payouts well over $20 billion, raise the question of how best to make sure the program works in ways that do not bust the federal budget in the future and indeed minimize taxpayer exposure. In this context, the subsidy of existing structures is an important consideration. When the flood insurance program began, it was assumed that existing structures would, over time, be "washed out" (literally or figuratively) from the program. But many subsidized structures remain in the program.

I believe that the time has come to find ways to lower the subsidy over the relatively short term. I submit the following ideas for your consideration:

- A 500-year mitigation and purchase requirement, rather than the current 100-year standard, would mean no subsidies in the areas that have experienced storms between 100-year and 500-year storm levels.

- Subsidies should be immediately ended on structures with market values in excess of some significant amount (for instance $500,000).

- Subsidies should be eliminated on all additional homes for an insured with more than one home.

- Subsidies should be phased out over a certain number of years (perhaps 10) on all structures with market values greater than, for example, $250,000 but less than $500,000.

- Subsidies should be eliminated on all structures that have experienced more than one flood with over $5,000 in program losses in the past.

- Subsidies should be reduced for homes with market values under $250,000 each time the home is sold. This should be done in increments that will eliminate the subsidy over three sales of the structure. Persons who have received flood insurance claims payments or flood disaster relief should not get a subsidy when purchasing a new home.

I must again raise the question of why private insurers cannot assume a greater role in writing flood insurance? The original reason insurers objected to a private role when the National Academy of Sciences (NAS) conducted a feasibility study was that they said they could not price policies to avoid adverse selection -- attracting properties that were extremely likely to be flooded. This concern could be resolved today by using technology to better assess risk and by requiring purchase of the coverage (perhaps up to the 500-year storm level) to assure the spread of risk. Congress should explore a long-term program to shift flood insurance back into the private sector where political pressures to bring rates below the actuarial level will not be present.

However, if the program is to remain a fully federal one, then why continue the Write Your Own Program (WYO)? It appears to be terribly expensive[4] and has not accomplished what insurers said it would (i.e., increasing market penetration of flood insurance). It results in wind/water claims adjustment conflicts of interest that could be avoided by using competitively bid contractors.

I continue to urge this Committee to immediately request a GAO study of the efficiency of the WYO program compared to those of competitively bid contractors. Such a study would likely show that the costs of the WYO program are too high, use of contractors should be expanded and the WYO contracts should be renegotiated to save significant taxpayer cost. At the very least, the payment of commission dollars to insurers who do not use commissions (such as USAA) should stop. Why should taxpayers pay agent commissions when no agent receives such commissions? Further, consideration should be given to having FEMA set only the part of the rate that covers the risk and let the WYO insurers add their own percentage loading for their costs, subject to a maximum load of, say, 25 percent.

Coverage levels should also be variable, at the consumer's option. The use of a higher deductible policy with a lower premium is one option that should exist. Policyholders could also be permitted to raise the $250,000 cap on coverage, but only at full actuarial prices, even for currently subsidized structures.

The 100-year storm standard for the elevation of new structures and the purchase requirement within that area should be revisited. Requiring coverage up to the 500-year storm for the nation would result in greater spread of risk, fewer surprises when storms occur and greater market penetration. The price for flood insurance outside the 100-year area would be very reasonable.

A very serious concern is the low market penetration that the flood insurance program has achieved. Over 2 million homes were insured in the 1970s when I left the program. In 2004 there were only 4.4 million, about double the 1970s level. In less than 10 years, we sold what it took an additional 15 years to match despite amazing population growth along the coasts and lender requirements to purchase insurance in the high flood hazard zones. Something is wrong.

One of the rationales for allowing insurers back into the NFIP was that they would achieve greater market penetration. They have failed to do a very good job other than to receive costly reimbursement for their servicing of policies. Further, the success of the lenders in requiring coverage on properties receiving new loans in flood prone areas is questionable and also needs to be studied. Are lenders failing to follow through to keep homes covered after they are purchased? I am aware that many lenders do have tracking programs to assure continuous coverage. However, questions persist because of the continued low penetration of flood coverage 35 years after the founding of the program. Better market penetration will help assure NFIP solvency.

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[4] The Committee should ask for this information from FEMA to determine the program's actual cost. I suggest not only looking at the costs of service compared to that of a competitively bid contractor but also to compare the cost to that of private insurers selling homeowners insurance (a more complex product than flood insurance and more costly to produce since homeowners insurance is not simply added to a policy as WYO flood insurance is). In 2004, underwriting expenses for the homeowners line were 28.4% of written premium, of which commissions were 13.0% and state taxes were 2.6% -- so that the comparable figure for servicing to compare to flood insurance is 12.8% (28.4% - {13.0% + 2.6%}). Source: Best's Aggregates & Averages, 2005 Edition.

Consideration should also be given to increasing the amount of mandatory coverage in at least the 100-year flood risk zone. Flood after flood shows market penetration of 10 to 20 percent. This is a serious problem. What is the "hook" for expanding mandatory coverage beyond the purchase requirement on federally backed mortgages, which appears not to work very well all by itself? This is a tough question, but an answer must be found. Perhaps non-federal lenders could be required by states to get flood cover on high-risk homes. As an incentive, federal benefits for flood plain management programs in participating states could be increased in those states that required their banks to require flood insurance coverage. A review of federal benefit programs in high-risk flood areas might reveal other ways to obtain greater mandates on structures/inhabitants in the flood plains. Also, communities could, as part of their flood management requirements to qualify for the NFIP, demand covenants on the sale of properties in flood plains stipulating that flood insurance must be carried in the future. I am not expert in these matters, but it is clear that experts on federal benefit programs and real estate should help find the answer to this vital question of expanding coverage in high-risk areas.

I have always thought that some of the burden for obtaining coverage for new structures should fall on the builders of these structures. Consideration should be given to requiring builders of new homes to purchase a 30-year (or at least a 5 or 10-year) policy. There are many advantages to this idea, including an immediate infusion of higher premiums into the program; but most important is the mitigation effect that such a requirement will have. Consider the difference in purchase price of two identical homes with builder-purchased flood coverage if one is built in harm's way the other is not. It won't take long for contractors to learn not to build in high-risk areas if they cannot market the high-risk homes.

There should also be verification by a GAO audit that participating communities forbid building in floodways and other V zones, such as storm surge areas. GAO should study the actual development that has taken place after the Flood Insurance Rate Maps ("FIRMs") were put in place in participating communities to see how the development conforms to the requirements of the FIRMs. If mitigation is not working, costs will go up and people will be killed. Mitigation failures must be fixed or the program will just encourage unwise construction into the future. Finally, the legislation to reduce losses to repetitively flooded properties passed by Congress last year should be a significant help in controlling costs.

In summary, the NFIP collects too little money to cover losses over the long haul. It now collects only enough to pay for relatively normal flooding in a year, with no long-term build up of reserves to cover larger than normal loss years. Katrina is but one example of this shortfall. But even bigger flooding events than Katrina are possible and, over the long-term, certain. Category 5 hurricane storm surges at high tide hitting Miami Beach or New York City and Long Island are examples of much larger potential flooding events. Stated simply, for the program to be actuarially sound, actuarially sound rates must be charged.

There are other steps beyond raising rates that should be taken to save money for the program, such as eliminating the excessive WYO expense charges for immediate savings and making sure that mitigation is fully enforced for longer-term savings. While these are necessary steps to bring the program into actuarial soundness, they are not sufficient. Only moving over time to full actuarial rates for all properties can achieve that.

2. <u>WYO Conflicts of Interest: Wind v. Water</u>

Since Hurricane Katrina devastated the Gulf Coast, there has been much public discussion about whether damage to homes was caused by wind and rain, or by flooding. Many policyholders have policies covering wind and rain damage (under homeowners' policies), but not flooding, which is a separate policy underwritten by NFIP. Many court challenges to the industry's no coverage determinations have begun.

The importance of this legal dispute to the flood insurance program is obvious. To the extent that insurers underpay wind when allocating damage between their homeowners' policy and the NFIP policy, taxpayers will suffer. It is also true that the more lax the federal government is in demanding that the allocation be fair to taxpayers, the more likely it is that persons without flood insurance will receive unfair or no compensation under their wind policies. Take the situation of two damaged homes next to each other, one with flood coverage and one without. If the federal government is vigilant regarding the home with flood coverage and the resulting allocation is 50/50 versus the insurer suggestion of 25 percent wind/75 percent flood, the insurer will be hard-pressed to assess the similarly damaged home next door at 25 percent wind damage.

For the benefit of taxpayers and those with no flood insurance, it is essential that the government assure a fair and proper allocation of the wind/flood damage by the WYO insurance companies who have a serious conflict of interest. CFA urges this Committee to insure that the GAO audits these allocations starting right now, so that any tendency of the insurers to diminish their wind losses for their own benefit is stopped quickly.

CONCLUSION

There are two crucial steps that must be taken to make the NFIP work properly. The first is making sure that mitigation works so taxpayers can realize the program's promise of reduced taxpayer exposure in the future. The second is moving to actuarial soundness.

I never thought I would utter the words that consideration must be given to ending this beautifully designed but hopelessly administered National Flood Insurance Program. However, repeal of the NFIP should be considered only as a last resort if the integrity of the program is not restored. This means bringing the program back quickly to its promise of covering all high-risk homes and businesses, eliminating unwise construction in the nation's flood plains and taking steps to ultimately achieve full actuarial soundness. This time, however, there must be tight oversight of FEMA's implementation of the program to achieve these vital goals.